

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Harman Analyst: Kimberly Pantoja Bill Number: AB 1366  
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 02/23/01  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Research Expenses Credit/24% of Energy Conservation & Efficiency Technology Research Costs

### SUMMARY

This bill would increase the credit for qualified research expenses from 15% to 24% of the costs of energy conservation and efficiency technology research and development.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to utilize the tax system to encourage research and development of energy conservation and efficiency technology.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The increased credit percentage for energy costs would be operative for taxable years beginning on or after January 1, 2001, and before January 1, 2008.

### POSITION

Pending.

#### Summary of Suggested Amendments

Amendments are provided to address the department's technical concern.

### ANALYSIS

#### FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

#### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

#### Department Director

#### Date

Alan Hunter for GHG

05/11/01

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

California conforms to the federal credit with the following modifications:

- ◆ The state credit is not combined with other business credits.
- ◆ Research must be conducted in California.
- ◆ The credit percentage for qualified research in California is 15% versus the 20% federal credit.
- ◆ The credit percentage for basic research in California, limited to corporations, is 24% versus the 20% federal credit.
- ◆ The percentages for the alternative incremental research portion of the credit vary from the federal credit.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

### THIS BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would increase the state credit for qualified research expenses with respect to energy conservation and efficiency technology research and development costs from 15% to 24%.

### IMPLEMENTATION CONSIDERATIONS

The bill uses terms that are undefined, i.e., "qualified costs," "energy conservation," and "efficiency technology." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of the credit.

Once this definitional problem is resolved, this credit could be implemented during the department's normal annual system update.

## TECHNICAL CONSIDERATIONS

Amendments 1 through 6 are provided to correct references from "income" year to "taxable" year.

## **LEGISLATIVE HISTORY**

AB 660 (Nakano, 2001/2002) and AB 1413 (Hollingsworth, 2001/2002) would increase the alternative incremental research expense credit to equal the prior federal credit percentages as they were on January 1, 1998. These bills are currently in the Assembly Revenue and Taxation Committee.

SB 1165 (Brulte, 2001/2002) and AB 483 (Harman, 2001/2002) would increase the credit for qualified research expenses from 15% to 20%. These bills are currently in the Revenue and Taxation Committees of their respective houses.

AB 465 (Nakano, Stats. 2000, Ch. 103) increased the state alternative incremental research expense credit to 85% of the prior federal amount, instead of the existing 80%.

AB 68 (Cunneen, 1999/2000), AB 1953 (Cunneen, 1999/2000), AB 2592 (Campbell, 1999/2000), SB 1495 (Brulte, 1999/2000), and SB 2200 (Dunn, 1999/2000) would have increased the qualified research expense credit percentage and would have decreased the minimum threshold for computing the credit. AB 68 failed to pass out of the Assembly by January 31 of the second year, AB 1953 was held in Assembly Appropriations Committee, AB 2592 was held in the Assembly Revenue and Taxation Committee, and SB 1495 and SB 2200 were held in the Senate Revenue and Taxation Committee.

SB 705 (Sher, Stats. 1999, Ch. 77) increased the state credit for qualified research expenses from 11% to 12%.

## **OTHER STATES' INFORMATION**

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

*Florida* excludes from the payroll factor for apportionment purposes compensation attributed to Florida that is dedicated exclusively to research and development activities performed pursuant to sponsored research contracts with a state university or certain nonpublic universities. This exclusion is for corporate income tax purposes only as Florida does not have a personal income tax.

*Illinois* corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in Illinois. The credit equals 6 1/2% of the qualifying expenditures.

*Massachusetts* corporate taxpayers, but not individuals, may claim an income tax credit for qualified expenditures that are used for increasing research activities in Massachusetts. The credit is 15% of the basic research expenses and 10% of qualified research expenses conducted in Massachusetts.

*Michigan, Minnesota, and New York* do not allow a research credit.

## **FISCAL IMPACT**

This bill is not expected to impact the department's costs significantly.

## **ECONOMIC IMPACT**

### Tax Revenue Estimate

The revenue impact of this bill is estimated to be revenue losses in the range of \$5 million to \$10 million annually. This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Estimate Discussion

The research credits generated under current and proposed laws are simulated for each corporation in a sample of the 50 corporations with the largest research and development expenses. These simulations take into account specific micro-economic data for each corporation such as gross receipts, wage, property, and sales factors, net income, historical research expenditures, and detailed tax and financial data. The results of the simulations are weighted statistically to the population level. The revenue losses are estimated to be the differences between the taxes simulated under current and proposed laws. Simulations are made for all qualified research expenses. The current energy crisis in California and its associated media attention are expected to raise energy-related research. Qualified energy conservation and efficiency technology research expenses are assumed to account for five to ten percent of the total qualified research expenses.

The Department of Finance forecast of corporate profits was used to extrapolate the estimates to future years.

The revenue impact for the PITL is assumed to be equal to 4.8% of the B&CTL impact and is added to the corporate impact.

## **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1366  
As Introduced February 23, 2001

AMENDMENT 1

On page 10, line 1, strike "income" and insert:

taxable

AMENDMENT 2

On page 10, line 18, strike "income" and insert:

taxable

AMENDMENT 3

On page 10, line 20, strike "income" and insert:

taxable

AMENDMENT 4

On page 13, line 38, strike "income" and insert:

taxable

AMENDMENT 5

On page 14, line 16, strike "income" and insert:

taxable

AMENDMENT 6

On page 14, line 18, strike "income" and insert:

taxable